

# CALIFORNIA FRANCHISE TAX BOARD

Legal Ruling No. 96-1

March 22, 1996

## APPLICATION OF THE SECTION 25128 DOUBLE OR SINGLE WEIGHTED SALES FACTOR TO NONUNITARY DIVISIONS OF A SINGLE CORPORATION AND TO PARTNERSHIP DISTRIBUTIONS

### ISSUES

1. If two or more divisions of a corporation are not unitary with each other, but the divisions are engaged in distinct unitary businesses with related corporations, is the more than 50% gross business receipts test of Section 25128 determined separately for each unitary business?
2. If a single corporation has two divisions engaged in nonunitary apportioning trades or businesses, one of which is engaged in an agricultural, extractive, or financial activity and the other of which is engaged in a general business activity, is the more than 50% gross business receipts test of Section 25128 determined separately for each division's trade or business?
3. If a corporation is a member of a partnership which is unitary with the corporation's trade or business, is the more than 50% gross business receipts test of Section 25128 determined by reference to the sum of the gross business receipts of the partner's own trade or business and the gross business receipts from its interest in the partnership's trade or business?
4. If a corporation is a member of a partnership which is not unitary with the corporation's trade or business, is the more than 50% gross business receipts test of Section 25128 determined at the partnership level or at the partner level?

### FACTS

Situation 1. Corporation A has two divisions, one of which is engaged in software manufacture, and the other of which is engaged in oil refining, both of which are conducted within and without the State of California. Wholly owned Subsidiary B distributes corporation A's software, and is unitary with the software division of Corporation A. Wholly owned Subsidiary C sells chemicals and gasoline, some of which is acquired by purchase from third parties, and some of which is acquired from Corporation A's refining division. Corporation A's refining division and C's sales activity are unitary. However, the software business and the refining-gasoline-chemical business are not unitary with each other.

Situation 2. Corporation D has two divisions engaged in two nonunitary trades or businesses doing business within and without the state. One trade or business manufactures aircraft parts, while the other trade or business grows wine grapes.

Situation 3. Corporation E is a food processor doing business within and without the state, and holds a 35% interest in a partnership which grows various agricultural products used in canning. Corporation E and the partnership are unitary.

Situation 4. Corporation F is a shoe manufacturer doing business within and without the state, and holds a 15% interest in a partnership engaged in oil and gas exploration. The partnership is not unitary with Corporation F.

## LAW AND ANALYSIS

If a single corporation is engaged in one trade or business conducted within and without the state, the business income of that corporation is subject to apportionment under the provisions of California's Uniform Division of Income for Tax Purposes Act (UDITPA)(Sections 25101, 25120-25139, Revenue and Taxation Code). If two or more corporations are engaged in a unitary business, the business income of the unitary group is combined, and the apportionment formula of Section 25128 Revenue and Taxation Code is applied to the unitary business income of the group to derive the group's income from California sources (Section 25101, Revenue and Taxation Code, Edison California Stores, Inc. v. McColgan (1947) 30 Cal.2d. 472).

However, if a single corporation is engaged in two or more nonunitary trades or businesses, then the income of each trade or business is separately apportioned by using the apportionment factors in an apportionment formula which takes into account the payroll, property and sales factors attributable to each such trade or business (18 Cal. Code of Regs. §25120(b)).

Section 25128 of the Revenue and Taxation Code generally provides that business income is apportioned to California by means of a four factor formula, consisting of a payroll factor, a property factor and a double weighted sales factor. However, Section 25128(b) provides that if a "taxpayer" has more than 50% of its "gross business receipts" from a qualified business activity, i.e., agricultural, extractive, and certain financial activity (hereinafter the "50% gross business receipts test"), then all of the income of the taxpayer shall be apportioned by a three factor formula, consisting of a payroll factor, a property factor, and a single weighted sales factor.

Section 25128(c)(7) provides that where two or more affiliated banks or corporations are included in a combined report, the entire business income of the group is apportioned using a single formula, consisting of either a single or double weighted sales factor. In that determination, the 50% gross business receipts test is made with respect to the gross business receipts of the entire group.

In Appeal of Finnigan Corp., August 25, 1988, 88-SBE-022, modif. by Opin. on Pet. Rehg., January 24, 1990, 88-SBE-022-A, the Board of Equalization held that the term "taxpayer" has two possible meanings throughout the provisions of California's UDITPA provisions, Sections 25120-25139, Revenue and Taxation Code. With respect to the combination and apportionment provisions of UDITPA, the term "taxpayer" refers to all

members of a combined unitary group. With respect to the allocation provisions of UDITPA (i.e., treatment of nonbusiness income), the term "taxpayer" refers to the specific corporate holder of the assets which produce nonbusiness income.

Section 25128(c)(7) requires that the 50% gross business receipts test of Section 25128 be separately computed with respect to each combined report group. Thus, if corporations in a commonly controlled group (Section 25105, Revenue and Taxation Code) consist of several distinct unitary groups, which are not unitary with each other, each of those groups are required to independently apply the 50% gross business receipts test with respect to the gross business receipts of each respective group. If a corporation has two or more divisions which are unitary with other members of separate and distinct combined reporting groups, under 18 Cal. Code of Regs. §25120(b), the income of each unitary business is required to be separately apportioned. To accommodate the requirements of both Section 25128(c)(7) and that regulation, the 50% gross business receipts test must be computed using the gross business receipts of the division and any unitary affiliates with which it is engaged in a unitary business.

Thus, in situation 1, two separate 50% gross business receipts tests are computed. One test is computed with respect to the gross business receipts of the refining-gasoline-chemical business (including the gross business receipts of Subsidiary C and the refining division of Corporation A). The other test is computed with respect to the gross business receipts of the software business (including the gross business receipts of Subsidiary B and the software division of Corporation A). If more than 50% of the refining-gasoline-chemical group's gross business income is from extractive activity, that group's business income is apportioned using a three factor formula. The income of the software group's business, as a general business activity, would be apportioned using a four factor formula.

As seen, despite the fact that Corporation A is a "taxpayer," in the sense of an entity subject to tax under Section 23151, for purposes of the 50% gross business receipts test of Section 25128, its nonunitary divisions are not tested together. As indicated in the Appeal of Finnigan Corporation, *supra*, with respect to apportionment of income, the term "taxpayer" must apply to the apportioning trade or business of the group. Thus, the term "taxpayer," as used in Section 25128(b), properly refers to an apportionable trade or business, and not to the specific entity subject to taxation.

FTB Legal Ruling 94-1, March 8, 1994, does not affect that analysis. Former Section §25128(c)(4), provided that, if a group of corporations is required to file a combined report, the term "taxpayer" appearing in Section 25128 referred to the entire group. The ruling merely provided that, because the application of Section 25128(c)(4) was limited solely to Section 25128, that provision did not codify the Finnigan holding for purposes of the other provisions of UDITPA. Nevertheless, unless reversed by a holding of an appellate court, Finnigan is the applicable law of its own force.

Applying the analysis that, for purposes of the apportionment provisions of UDITPA, "taxpayer" means apportioning trade or business, if a single corporation has corporate divisions engaged in two or more distinct nonunitary trades or businesses, each subject to

its own apportionment under 18 Cal. Code of Regs. §25120(b), the application of the 50% gross business receipts test used for determination of single or double weighting under Section 25128 should be made with respect to each separate unitary business.

Thus, in situation 2, the aircraft parts division and the wine grape division should be separately tested under Section 25128. If the wine grape division satisfies the 50% gross business receipts test with respect to its agricultural activity, income from that division will be apportioned using a three factor formula. The aircraft parts division will be apportioned using a four factor formula.

The provisions of 18 Cal. Code of Regs. §25137-1 state the rules for apportionment of income from a partnership which is received by a corporate partner. Generally, if the business activity of the partnership and the corporate partner are unitary (disregarding unity of ownership), the corporate partner adds its distributive share of partnership business income to its own business income and apportions the resulting net income using an apportionment formula consisting of the aggregate of its own payroll, property, and sales and its share of the partnership's payroll, property, and sales, in accordance with the partner's interest in the partnership (18 Cal. Code of Regs. §25137-1(f)). The resulting combined income represents the corporation's total business income from a single unitary business enterprise. Thus, income from the entire apportionable business activity is properly apportioned using a three or four factor formula, applying the 50% gross business receipts test of Section 25128. For purposes of that test, the corporation uses the sum of its own gross business receipts and its interest in the partnership's gross business receipts.

Thus, in situation 3, corporation E applies the 50% gross business receipts test of Section 25128 with respect to the sum of its own gross business receipts and its 35% interest in the partnership's gross business receipts.

If a partner is not unitary with its partnership, 18 Cal. Code of Regs. §25137-1(a) and (g) generally provide that the corporate partner's distributable share is treated as a separate trade or business of the partner. However, 18 Cal. Code of Regs. §25137(g)(1) specifically provides the mechanism:

(g)(1) If the partnership derives business income from sources within and without this state, the amount of business income within this state shall be determined on the basis of a three factor formula...After determining the amount of business income attributable to this state by the three factor formula, the taxpayer's distributive share of such business income shall be treated as business income from a separate business by the taxpayer.

Thus, only *after* the amount of business income attributable to California is determined by apportionment at the partnership level, is the resulting distributive share treated as a separate trade or business of the taxpayer. Accordingly, the apportionment of income of a partnership which is not unitary with its partner is conducted at the partnership level prior to distribution.

Despite the language of 18 Cal. Code of Regs. §25137-1(g)(1), which indicates that a nonunitary partnership's income is to be apportioned "on the basis of a three factor formula of payroll, property and sales," the application of a three or four factor apportionment formula is governed by Section 25128. The regulation was promulgated before enactment of Section 25128, and must be interpreted in light of superseding statute (see, Scholfield v. Lewis (8th Cir., 1958) 251 F.2d. 128). Accordingly, for a nonunitary partner, the determination whether the partner's distributive share of partnership business income will reflect three or four factor apportionment is governed by whether the 50% gross receipts test of Section 25128 is satisfied at the partnership level.

Thus, in situation 4, the income of the oil and gas partnership is tested under Section 25128 at the partnership level. Assuming the 50% gross business receipts test with respect to the partnership's extractive activity is satisfied at the partnership level, Corporation F receives its distributive share of the partnership's income which reflects three factor apportionment, and will apportion the income from its shoe manufacturing enterprise using a four factor formula. Accordingly, Corporation F's California source income subject to taxation is the sum or net of the following: 1) Corporation F's share of income of the partnership which is apportioned to California (using a three factor formula), and 2) Corporation F's income from its shoe manufacturing business which is apportioned to California (using a four factor formula).

## HOLDINGS

1. If a corporation has two or more divisions which are not unitary with each other, but the divisions are unitary with other related corporations, the 50% gross business receipts test of Section 25128 must be computed using the gross business receipts of the division and any subsidiary with which it is engaged in a unitary business.
2. If a single corporation has two or more divisions engaged in trades or businesses which are not unitary with each other, the 50% gross business receipts test under Section 25128 must be separately computed for each trade or business.
3. If a corporation is a member of a partnership, and is engaged in a unitary business with that partnership, the 50% gross business receipts test under Section 25128 is determined by reference to the sum of the gross business receipts of the corporation and its interest in the gross business receipts of the partnership.
4. If a corporation is a member of a partnership, and is not engaged in a unitary business with that partnership, the 50% gross business receipts test of Section 25128 is determined at the partnership level by reference to the partnership's gross business receipts. Only after the partnership business income is so apportioned, does the partnership distribute the partner's distributive share, which in part consists of the partner's share of California apportioned income.

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